

U.S. Taxpayers Living Abroad

*An explanation of the tax rules
and how they have been changed for 1978 and later years.*

Touche Ross & Co.



INTRODUCTION	1
WHAT ARE THE 1978 RULES	2
Hardship exclusion; Cost of living; Education; Home leave; Hardship cost; Housing; Moving and sale of residence.	
FILING & WITHHOLDING REQUIREMENTS.....	6
Who must file; Joint returns; Special head-of- household rule; Joint vs. separate returns; When to file; Additional time for filing; Alternative first-year filing procedures; Interest on balance due; Where to file; Relief from withholding requirements; Foreign withholding; Estimated tax.	
QUALIFYING FOR TAX BENEFITS	11
Who may qualify; Need for earned income abroad; Salaries, etc.; Business income; Partnership; Source of income; Time of receipt; Community property.	
QUALIFYING PERIOD	14
Bona fide foreign resident; Change of residence; Partial year BFFR; Physical presence abroad.	
OTHER TYPES OF INCOME	18
Dividends; Interest; Rental income; Royalties; Capital gains; Pensions.	
ADJUSTED GROSS INCOME, DEDUCTIONS AND EXEMPTIONS	20
Adjusted gross income; Zero bracket amount; Medical expense; Charitable; Interest; Taxes; Losses; Rental of residence; Business and investment expenses; Tax shelter; Foreign conventions; Exemptions; General tax credit.	
FOREIGN TAX CREDIT	26
Limitation; Allocation of expenses; Cash or accrual option; Carryovers; Use of excess credit; Sale of securities; Foreign investments; Business trips.	
SPECIAL ASSET METHODS	33
FICA; Self employment taxes; Individual retirement accounts.	

INTRODUCTION

This booklet, like earlier editions, explains some of the particular tax problems likely to be encountered by a U.S. citizen or resident alien living abroad. Such taxpayers are subject to the same United States income tax laws as their stateside counterparts. They must file U.S. tax returns, use the same form and the same tax rates; but there is one important difference—these taxpayers are entitled to a group of special deductions. In some situations, an outright exclusion from income is allowed. This difference can provide a significant tax benefit, but it is well to remember that income earned abroad frequently is subject to foreign taxes. A measure of relief is provided by foreign tax credits.

We will discuss these matters in some detail and review briefly a number of other tax questions which should be of interest. Unfortunately, space does not permit review of such matters as the minimum tax on preferences (a 15% additional tax imposed on specified items of income, such as capital gains, or on deductions, such as accelerated depreciation, which receive "preferential" treatment); maximum tax on personal service income (the tax on compensation and retirement income in the form of a pension may not be greater than a 50% rate); estate and gift taxes, etc. State and local tax laws may also apply to U.S. taxpayers living abroad, and these not only may differ from U.S. tax rules but are also likely to be different from one state or locality to another.

The rules affecting U.S. taxpayers abroad were always complex but at least they were unchanging. In recent years, there was considerable uncertainty over just what rules would apply for U.S. taxpayers abroad. This uncertainty was finally resolved in 1978 with the enactment of the Foreign Earned Income Act of 1978. A description of these new rules and a brief comparison with the rules of earlier years is presented at this point. Many of the tax planning opportunities for U.S. taxpayers abroad will center on these new rules and an understanding of them is necessary in making any tax decisions.

Prior to the Tax Reform Act of 1976, U.S. taxpayers working abroad could exclude up to \$20,000 of earned income a year if the taxpayer was present in a foreign country for 17 out of 18 months, or if he qualified as a bona fide resident of the foreign country for the entire year. An exclusion of \$25,000 was available to U.S. citizens who had resided abroad for 3 years or more.

The Tax Reform Act of 1976 included a number of unpopular and controversial changes. In place of the \$20,000/\$25,000 exclusion, the Act permitted only \$15,000 per year, at the taxpayer's lowest tax bracket. In addition, the Act disallowed a foreign tax credit for any foreign taxes attributable to the \$15,000 of excluded income. The provisions established by the 1976 Act were to become effective for taxable years beginning after 1975, but were delayed to 1977 by subsequent legislation.

Effective with the signing by President Carter of the Foreign Earned Income Act of 1978 on November 8, 1978, the 1976 Tax Reform Act rules were repealed for 1977 and thereafter. The Internal Revenue Service (IRS) has granted an extension until February 15, 1979 for the filing of 1977 returns for qualifying taxpayers. For 1978 only, the 1976 Act rules can be elected, although it is probable that, for most taxpayers, the election will not save tax.

For taxable years beginning on or after January 1, 1978, qualifying U.S. taxpayers living abroad* will be taxed under completely new rules. Under these provisions, the earned

*Qualification, as under rules of earlier years, is based either on bona fide residence in a foreign country or presence in a foreign country for 17 out of 18 consecutive months.

income exclusion is repealed, with one exception, and replaced by a series of provisions which allow deductions for cost of living, housing, education and certain other expenses. These deductions are allowable in the calculation of adjusted gross income. They can be claimed even if a taxpayer does not itemize his deductions but uses instead the zero bracket amount (ZBA) which has replaced the standard deduction.

HARDSHIP EXCLUSION

The one exception to the repeal of the earned income exclusion allows a \$20,000 annual income exclusion to employees residing in camps in "hardship areas" who are bona fide residents of a foreign country for the entire taxable year or who are present in a foreign country seventeen out of eighteen months. Camp-style lodging is defined as substandard housing provided in remote hardship areas close to the jobsite where alternative housing is not available on the open market. The value of the lodging supplied by the employer is excluded from the income of the employee. The \$20,000 annual exclusion for employees in camps is an election in lieu of the living, housing, schooling, and home leave deductions discussed below.

Hardship areas are those foreign locations designated as such by the Secretary of State where extraordinarily difficult living conditions, notably unhealthy conditions, or excessive physical hardship exist and for which a federal government post differential of at least 15 percent is allowed. A list of these locations would include perhaps 100 countries, and in these countries, some or all of the locations there may qualify as hardship areas.

"Extraordinarily difficult living conditions" includes inadequate housing accommodations, lack of cultural and recreational facilities, geographic isolation and inadequate transportation facilities, and lack of food and consumer services. "Excessive physical hardship" involves the effects of climate and altitude and the presence of dangerous conditions affecting life, mental health, or physical well-being. "Notably unhealthy conditions" involves the incidence of diseases and epidemics, lack of public sanitation, and health-control measures and inadequacy of medical and hospital facilities.

We would expect that most readers of this booklet will not be residing in hardship areas. Their tax relief comes from a series of special deductions.

COST OF LIVING

Qualifying U.S. taxpayers are entitled to a cost of living deduction starting January 1, 1978. The deduction will be determined under an IRS table showing the cost of living in various foreign places for families of various sizes. The table will be based on the spendable income of a person paid the salary of a federal government employee at the GS-14, step-1 level (currently \$32,442). The calculation of the deduction is mechanical and does not depend upon actual income or amounts expended.

EDUCATION

Qualifying U.S. taxpayers will be able to deduct the reasonable schooling expenses for the education of their dependents at the elementary and secondary level. This includes the cost of tuition, fees, books, and local transportation. If an adequate U.S. type school is not available within a reasonable commuting distance, taxpayers who send their dependents to such schools at any location will be entitled to deduct the cost of room and board, as well as transportation costs associated with such schooling.

HOME LEAVE

Qualifying U.S. taxpayers will be able to deduct the cost (coach or economy class airfare only) of one round trip annually for the taxpayer, his spouse, and each dependent, from their foreign location to the location of their last principal residence in the U.S. If the taxpayer does not have such a principal residence in the U.S., the home leave transportation deduction is measured by the cost of a round-trip fare from the foreign location to the nearest port of entry in the continental United States.

HOUSING

Qualifying U.S. taxpayers will be entitled to a deduction equal to the excess of the individual's actual housing expenses over his "base housing amount." Housing expenses include rent, utilities, insurance, repairs and maintenance and any other reasonably related expenses. Interest and taxes are not considered housing expenses.

Base housing amount is defined as one-fifth of the excess of his earned income (minus applicable business deductions) over the sum of his actual housing expenses and the above deductions. If due to the adverse living conditions of his place of employment, a taxpayer maintains a separate household outside of the U.S. for his family, he will be entitled to deduct the full cost of his own housing abroad. The Conference Committee report on the tax law indicates that the requirement of "adverse living conditions" at the place of employment is to be liberally construed, which suggests that the area need not be so bad as to qualify as "hardship."

HARDSHIP POSTS

Qualifying U.S. taxpayers who work in hardship areas and do not claim the \$20,000 hardship exclusion will be entitled to an additional hardship deduction of \$5,000 a year, based on the number of days in such hardship area.

MOVING AND SALE OF RESIDENCE

In addition to the above provisions affecting taxpayers working abroad, there are several changes in the law designed to ease the move between the United States and a foreign country. Taxpayers are generally allowed to deduct as moving expenses their temporary living costs for a 30-day period, to a maximum of \$1,500. The Foreign Earned Income Act of 1978 extends the temporary living arrangements period from 30 to 90 days, and raises the ceiling from \$1,500 to \$4,500. The maximum deduction for qualified expenses related to the sale, purchase or lease of a principal residence is increased from \$3,000 to \$6,000. Deductible moving expenses connected with a move to a foreign country will also include the cost of storing goods while abroad. Special rules eliminate the moving expense deductibility ceilings for retirees returning to the United States after working abroad and the survivors of Americans who died while working overseas.

Under the general U.S. tax rules for the tax-free rollover on the sale of a residence, a taxpayer must reinvest the proceeds of the sale of his home within eighteen months. For U.S. taxpayers living in a foreign country, whether or not they meet physical presence or residence tests, that period is extended to a maximum of four years after the date of sale of the old residence.

FILING AND WITHHOLDING REQUIREMENTS

WHO MUST FILE

U.S. citizens and aliens who retain their U.S. resident status* while residing in foreign countries must file U.S. income tax returns for 1978 if gross income is at least \$2,950 (\$3,700 if age 65 by the end of the year); married taxpayers who are entitled to file joint returns will be required to file only if their combined gross income is at least \$4,700 (\$5,450 if one spouse has reached age 65, or \$6,200 if both have). In determining these amounts, all compensation earned abroad is included in gross income; income which is excludable for other reasons, such as interest on tax-free municipal bonds, is not. A tax return must be filed even though the taxpayer's deductions (special foreign deductions or exclusions, zero bracket amount or itemized and personal exemptions) equal or exceed his gross income, or when credits, such as the general tax credit or the foreign tax credit, completely eliminate the taxes which would otherwise be due.

JOINT RETURNS

U.S. citizens or residents married to a nonresident alien can elect to file a joint return if they agree to be taxed on their worldwide income. This election can, however, be terminated in later years by death, revocation, or separation. In the event such

For tax purposes, an alien usually becomes a resident on the date he arrives in the U.S. with the intent to become a resident. An alien arriving in the U.S. who is married to either a U.S. citizen or a resident alien is rebuttably presumed to have this intent upon arrival, as are nonresident aliens who remain in the U.S. for more than one year.

Once an alien becomes a U.S. resident he does not lose that status merely because he leaves the country; the departure from the U.S. must be coupled with the intent to relinquish residence. A resident alien will, therefore, continue to be a resident and subject to U.S. tax on his worldwide income after his departure from the U.S. unless he can establish that he gave up his resident status. Resident aliens should consider the desirability of retaining U.S. resident status very carefully; while ending U.S. resident status would terminate the U.S. taxation of foreign income, it would also interrupt the required residence period of aliens who wish to become U.S. citizens and may have other legal implications.

an election is not made, or is later terminated, then for 1978 and later years, community property laws are inapplicable for income tax purposes. The effect is to prevent one-half the couple's income from escaping U.S. tax.

If the election is not made, a married nonresident alien who has no gross income from U.S. sources may be claimed as a dependent on the spouse's return; applicable additional exemptions on account of blindness and/or age may also be claimed.

SPECIAL HEAD-OF-HOUSEHOLD RULE

A U.S. citizen who is married to a nonresident alien and does not make the above election, is considered unmarried for the purpose of determining which tax rate schedule may be used. Therefore, such citizen may, in addition to claiming an exemption for his nonresident alien spouse, file as head of household if the taxpayer otherwise qualifies.

JOINT vs SEPARATE RETURNS

The election for a nonresident alien to file a joint return is binding for future years unless terminated. Other married taxpayers (including those where either, or both, is a resident alien) may decide each year whether to file a joint return. Taxpayers should calculate their U.S. income taxes on both separate and joint bases to determine which results in a lower total tax. While joint returns in almost all instances result in lower taxes, taxes might be lower on a separate return basis. For example, if each spouse has a similar amount of income but one has unusually high medical expenses, separate returns may result in a lower combined tax.

WHEN TO FILE

Although tax returns for individuals are due on the 15th day of the fourth month following the close of the taxable year (April 15 for calendar year taxpayers), taxpayers who are U.S. citizens and who are outside the U.S. on the regular due date have an automatic extension of two months (to June 15 for calendar year taxpayers) for filing. While no formal request for this additional time is necessary, the taxpayer's return must state that he or she was outside the U.S. on the regular date for filing. If the taxpayer is a resident alien traveling or living

abroad, an *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return (Form 4868)* is required to be filed.

If the due date for filing a return (including the automatic extension discussed above) falls on a Saturday, Sunday or national holiday, the due date is the first subsequent business day. In 1979, April 15 is a Sunday and June 15 is a Friday; returns must be filed on April 16 and June 15.

ADDITIONAL TIME FOR FILING

Taxpayers who need time in addition to that available from the automatic extension may request an additional time on an *Application for Extension of Time to File Individual Income Tax Returns (Form 2688)*. This does not apply to declarations of estimated tax.

ALTERNATIVE FIRST-YEAR FILING PROCEDURES

A taxpayer who expects to qualify for the special foreign deductions or exclusions but is required to file a return before qualifying, may either obtain an extension of time to defer filing the return until such time as he qualifies, or file the return without claiming the special foreign deductions or exclusions, pay any tax due, and file for a refund when the requirements are met.

The Internal Revenue Service will grant an extension of time for filing a tax return until 30 days after the date on which the requirements for qualifying as a Bona Fide Foreign Resident (BFFR) or physical-presence basis are met. This extension must be requested, in duplicate, on *Application for Extension of Time for Filing U.S. Income Tax Return (Form 2350)* on or before the due date for filing the tax return. For example, a U.S. citizen who arrived overseas during 1978 (whose return would be due on April 16 or June 15, 1979, with the automatic extension) would not have to file that return until January 30, 1980 if he expects to claim the special foreign deductions or exclusions that may be available. The applications for the extension may be filed with either the Internal Revenue Service Center in Philadelphia, Pennsylvania, or a local IRS representative. A copy of the approved application must be attached to the return when it is filed.

Filing a U.S. tax return without claiming the special foreign deductions or exclusions usually requires payment of U.S. taxes, especially where the taxpayer's compensation has not been subjected to U.S. withholding. Although a portion or all of

these taxes may be refundable at a later date, it is usually advantageous to obtain the extension of time and file the return when the special foreign deductions or exclusion can be claimed. On the other hand, a taxpayer who already is entitled to a refund may consider it worthwhile to file on the original due date and obtain the refund. At a later date, he may file an amended return (Form 1040X) to obtain a further refund because of the special foreign deductions or exclusions. (This situation often occurs when a foreign assignment begins toward the end of the year.)

INTEREST ON BALANCE DUE

An extension of time for filing the return also extends the time for paying any tax due. Interest is charged, however, on any balance due from April 16, 1979 until it is paid. Payment can be made with an extension request to save this cost.

WHERE TO FILE

Taxpayers who claim the special foreign deduction or exclusion should file all returns with the Internal Revenue Service Center in Philadelphia, Pennsylvania. Payments should be made to the office in which the return or declaration of estimated tax is filed. Taxes are payable in U.S. dollars; foreign bank checks must be drawn on U.S. dollar accounts. Claims for refund or amended tax returns should be filed in the district in which the return to which they relate was filed.

RELIEF FROM WITHHOLDING REQUIREMENTS

A U.S. employer is not required to withhold income tax from compensation earned abroad unless it exceeds the special foreign deductions or exclusions. A U.S. taxpayer who expects to qualify should notify his employer in writing to terminate the withholding of income taxes. This protects the employer from possible future liability for failure to withhold if the employee fails both to qualify and to pay any tax due.

Example: William Smith's annual salary of \$84,000 in 1979 (of which he may claim special foreign deductions of \$28,000) is payable at the rate of \$7,000 monthly. According to IRS regulations proposed on January 2, 1979, \$2,333 of each monthly payment is not subject to withholding. (\$28,000/84,000 x \$7,000.)

FOREIGN WITHHOLDING

Regardless of whether compensation qualifies for the special foreign deductions or exclusions, compensation paid by U.S. employers for services performed abroad is not subject to U.S. withholding if the income is required by foreign law to have foreign withholding.

ESTIMATED TAX

Estimated tax declarations are required if gross income exceeds \$20,000 for a single person, head of household, surviving spouse and a married person whose spouse does not receive wages (\$10,000 for a married couple if both work). An estimated tax return is also required if gross income is expected to include more than \$500 of income from sources other than wages subject to withholding, which is true of many U.S. citizens living abroad. A declaration is not required, however, if estimated taxes after withholding are not expected to exceed \$100. This "escape clause" enables many taxpayers to avoid the filing of a declaration. Declaration and payment dates are April 15, June 15, September 15, and January 15.

QUALIFYING FOR TAX BENEFITS

WHO MAY QUALIFY

A U.S. citizen who claims special foreign deductions or exclusions must qualify either as a Bona Fide Foreign Resident (BFFR) or be physically present in a foreign country 510 days in a consecutive 18-month period. The physical presence test can also be met by all resident aliens.

To qualify as a BFFR, a U.S. citizen must reside in a foreign country for a period which includes at least an entire taxable year, one which begins before January 1 and ends after December 31 of the same year for a calendar year taxpayer. Merely being in a foreign country for the required amount of time is not sufficient; qualification as a BFFR depends upon the establishment of a residence abroad coupled with the "intent" to become a foreign resident. In determining a taxpayer's intent the courts have considered factors such as the duration and nature of his stay; the type of foreign visa obtained; whether he has abandoned in favor of one in the foreign country; whether the individual was accompanied by his family; the nature and degree of his participation in the foreign community; etc. The fact that the taxpayer intends to return to the U.S. after his foreign assignment does not prevent him from becoming a BFFR. A person who is a transient — one who travels abroad for a temporary period of time for a definite purpose — is not a BFFR. The following examples illustrate the two extremes.

Example: William Smith, a U.S. citizen, moved to the United Kingdom with the intention of residing and working there for an indefinite period of time. He plans to return to the U.S. after his assignment is completed. He rented his home in the U.S., he took his family and home furnishings with him to the U.K. Smith should qualify as a BFFR.

Example: Peter Jones, a U.S. citizen, works in the United Kingdom for 13 months. He leaves his family in the U.S. Jones is probably not a BFFR.

To qualify based on physical presence abroad the individual must be in foreign countries for 510 days (17 months) in a consecutive 18-month period; intent and residence are irrelevant. All that is required is that the taxpayer actually be

present on foreign soil. Time spent in a foreign country in the employment of the U.S. Government will count toward satisfaction of the 510 full-day requirement. The amount of the allowable special foreign deductions or exclusions may be greater in the first and last years of an overseas assignment if the physical presence, not the BFFR, rule is used. (See page 15.)

NEED FOR EARNED INCOME ABROAD

The special foreign deductions or exclusions are only allowed if the taxpayer has earned income from sources outside the United States and they may not exceed the amount of earned income reduced by allocable deductions.

SALARIES, ETC.

Salaries and wages, commissions, professional and consulting fees, noncash remuneration, housing and post allowances, and bonuses constitute earned income. Amounts received from any agency of the U.S. Government, whether or not received for the performance of services, are not considered earned income; however, wages paid by a private employer which receives its income from government sources qualify.

BUSINESS INCOME

Broadly speaking, business income is generally regarded as "unearned" income. However, a proprietor or professional person whose personal services are a direct material factor in producing the gross income may treat part (or all) of his business income as earned income.

When both capital and personal services are material income-producing factors, a proprietor can treat a reasonable amount of his business income as compensation earned abroad, but not more than 30% of net income. (For 1979 and later years, the 30% rule does not apply.)

PARTNERSHIP INCOME

The rules governing a sole proprietor's business income also apply to the exclusion of partnership income.

Separate rules, however, apply to the resident partners in a foreign branch of a U.S. partnership. If the partnership agreement provides that those partners will share in the worldwide profits of the partnership, the partner whose personal services earned the foreign income may not treat as

earned income more than his share of the total partnership profits multiplied by the ratio of the partnership's foreign to worldwide earned income. If the partner working abroad received a guaranteed payment — i.e., he receives payments regardless of the amount of the partnership's foreign earnings — the guaranteed payment will qualify as earned income. (The partner must, of course, otherwise qualify for the special foreign deductions or exclusions.)

SOURCE OF INCOME

Compensation for the performance of personal services has as its source the place at which the services are performed; factors such as the place from which payment is made, the location of the employer, the home base of the employee, etc., are not significant. (Note: The source of income is important in calculating the allowable foreign tax credit — see page 27.)

Compensation which relates to any services performed in the U.S. is not foreign source since it is not earned abroad. (Even if the taxpayer has BFFR status, which, once established, is not interrupted by visits to the U.S. regardless of the reason.)

TIME OF RECEIPT

Earned income which otherwise qualifies for the special foreign deductions or exclusions must not be received later than the end of the year following the year in which the services were performed. This could affect the applicable limitations on the special foreign deductions or exclusions.

COMMUNITY PROPERTY

Some states in the U.S. and some foreign countries have community property laws which generally provide that one-half of either spouse's income is the property (income) of the other spouse. The test of whether income will be subject to community property laws is based upon where a taxpayer is domiciled. Domicile is different from residence and has been defined, generally, as that place where a taxpayer has his true, fixed and permanent home to which he has the intention of returning. If separate returns are filed, one-half of the special foreign deductions or exclusions would be claimed on the separate returns. A double deduction is not allowed for the same foreign living costs. However, each spouse would be entitled to claim the \$20,000 camp exclusion if they each qualify.

QUALIFYING PERIOD

BONA FIDE FOREIGN RESIDENT

The taxpayer must qualify as a BFFR for a period which includes at least one full taxable year before he can be entitled to claim any special foreign deductions or exclusions. An entire taxable year for a calendar year taxpayer begins on January 1 and ends the following December 31.

Example: William Smith arrived in the U.K. on January 19, 1978. He will not qualify as a BFFR until January 1, 1980. If he departs from London on December 13, 1979, he cannot qualify as a BFFR. If Smith had arrived in London on December 31, 1977, he would have qualified on January 1, 1979.

However, once the taxpayer qualifies as a BFFR, the status applies from his first day of residence. In the previous example, although Smith will not qualify as a BFFR until January 1, 1980, he will, upon qualification, be entitled to the special foreign deductions or exclusions based on compensation earned from January 20, 1978. As shown in the explanation of the physical presence rules, the period of eligible compensation might even start earlier.

Once BFFR status has been established, business and pleasure trips to the U.S. may be made without jeopardizing that status. There is no reduction in the special foreign deductions or exclusions due to the taxpayer's absence from his foreign tax home.

If the camp exclusion is claimed, the amount of the exclusion is prorated to reflect the number of days the taxpayer resides in the camp. Since temporary absences do not terminate camp residence, the exclusion should not be reduced. Similar considerations affect taxpayers electing (for 1978 only) the provisions of the Tax Reform Act of 1976. The fact that the U.S. taxpayer pays no foreign income taxes on the compensation earned abroad does not preclude his claiming the special foreign deductions or exclusions. Where foreign taxes are avoided because the taxpayer holds himself out as a nonresident to the foreign tax authorities, no special foreign deductions or exclusions under the BFFR rules may be claimed. On the other hand, a tax exemption by a foreign country under the provisions of a treaty or other international agreement does not mean that the taxpayer is considered to be a nonresident of that country.

CHANGE OF RESIDENCE

A change of foreign residence to another foreign residence does not affect status as a BFFR. However, even temporary residence in the U.S. between foreign assignments could terminate BFFR status. A taxpayer should, therefore, maintain a former foreign residence until a new foreign residence is acquired in order to avoid interrupting his period of BFFR.

PARTIAL YEAR BFFR

The taxpayer who arrives in or departs from a foreign country during a year can qualify only for the part of the year that he resided in the foreign country.

Example: Alfred Smith, a calendar year taxpayer, became a resident of Tokyo on March 31, 1978. Assuming that he will qualify for the special foreign deductions, his educational deductions, home leave deductions and housing deductions will be determined by the costs *actually* incurred while he is a BFFR of Tokyo. His cost of living deduction will be prorated as follows (assuming full year cost of living allowance for a family the size of Alfred Smith's is \$6,000):

Days in Year as BFFR	Maximum Deduction	Deduction for 1978
$\frac{275}{365}$	$\times \$6,000$	$= \$4,521$

A similar calculation would be made if the exclusions were taken instead of the special foreign deductions. The same formula is used if status as BFFR terminates during a year.

PHYSICAL PRESENCE ABROAD

A U.S. taxpayer is required to be physically present abroad at least 510 full days in any consecutive 18-month period to claim the special foreign deductions or exclusions.

A day is defined as a 24-hour period beginning at midnight, for both arrival and departure.

Example: William Smith departs from the U.S. at 12:30 p.m. on January 1 and arrives in England at 12:01 a.m. local time, January 2. Mr. Smith's first full day on foreign soil is January 3. Had he arrived at 11:59 p.m. on January 1, January 2 would have been the first full day.

If a foreign country is flown over prior to midnight (after departing from the U.S.) and there is no travel in the U.S. (or possessions) before arriving in a foreign country on the following day, the first full day on foreign soil is the day of arrival.

Example: William Smith departs from the U.S. on January 1 at 1:00 p.m. He flies over the coast of Ireland at 11:50 p.m. and lands in Sweden at 2:00 a.m. on January 2. Mr. Smith's first full day on foreign soil is January 2.

The required 18-month period must be consecutive. It need not, however, begin upon arrival abroad nor must it end with the departure. Two or more 18-month periods may overlap; there may be a gap between periods. The goal is to have as many days as possible in any taxable year fall within an 18-month period.

Example: William Smith arrived in the United Kingdom on March 4, 1975. He left the U.K. on May 11 for a brief visit to the U.S. and returned to the U.K. on May 25. Smith was transferred to Venezuela and stopped in the U.S. between assignments; he left the U.K. on April 29, 1976 and arrived in Venezuela on May 10, 1976. Smith left Venezuela for the U.S. on October 10, 1976, and remained in this country awaiting a new assignment. He was sent to Brazil where he arrived on December 15, 1976. He remained in Brazil until August 7, 1977, at which time he was transferred to Peru. He went directly to Peru from Brazil without returning to the U.S. and remained there until his reassignment back to the U.S. on May 10, 1978. Several 18-month periods may be arrived at as follows:

Days Abroad

1st period:

February 23, 1975 through August 22, 1976

2/24/75 — 3/4/75	0
3/5/75 — 5/10/75 (U.K.)	67
5/11/75 — 5/25/75	0
5/26/75 — 4/28/76 (U.K.)	339
4/29/76 — 5/10/76	0
5/11/76 — 8/21/76 (Venezuela)	104
Total Full Days	510

2nd period:

May 26, 1975 through November 25, 1976

5/26/75 — 4/28/76 (U.K.)	339
4/29/76 — 5/10/76	0
5/11/76 — 10/29/76 (Venezuela)	171
10/29/76 — 11/25/76	0
Total Full Days	510

3rd period:

December 15, 1976 through June 16, 1978

12/17/76 — 8/7/77 (Brazil)	234
8/8/77 — 5/10/78 (Peru)	276
5/11/76 — 6/16/78	0
Total Full Days	510

For the first year of physical presence, determine the first day of the 18-month period by counting back 18 months from the 510th full day of physical presence abroad. Then count the number of days between the first day of that period and the end of the year. The year the taxpayer returns from his foreign assignment, the number of days which count in that year may be increased if the first day of the 510-day period ending on the taxpayer's last day of physical presence abroad is also the first day of the 18-month period.

OTHER TYPES OF INCOME

Whether a taxpayer claims the special foreign deductions or exclusions, other income, such as dividends, interest, capital gains, etc., is taxed as if the taxpayer had never left the United States. If such income is from foreign sources, this will affect the foreign tax credit limit (see page 27).

Dividends received are subject to tax. In the event a dividend is received in a form other than cash, its fair market value is included in gross income. Each U.S. citizen, whether or not a U.S. resident, can exclude from his gross income \$100 dividends received from most U.S. corporations. This exclusion does not apply to dividends received from a foreign corporation.

Interest received is subject to tax unless received on an obligation of a state, county, city, or municipality in the U.S. (or their political subdivisions).

Rental income received for property is includible in gross income regardless of the property's location and expenses incurred are deductible. (There is an important exception for income and expense in connection with a residence. This is discussed in the section on deductions.) Depreciation is permitted, but if taken on foreign property it must be calculated in accordance with U.S. tax rules regardless of the method used for foreign tax accounting purposes.

The depreciation on property once held for personal use but which was converted to rental property is calculated on the lower of the property's adjusted basis or fair market value on the date of conversion.

Royalties received for the right to exploit mineral property, patents, know-how, or other intangibles are included in taxable income but may be reduced by amortization and any direct expenses.

Another type of royalty—from writing or musical compositions—is, or is not, earned income depending on the particular contractual arrangement between the writer or composer and his publisher. If you write a book and sell the manuscript outright, or if you assign copyrights to a publisher, the proceeds are not earned income.

On the other hand, if you enter into a contract to write a book, or articles, or one or more musical compositions for a determinable amount in remuneration, or remuneration plus a commission on sales, the income is considered earned income.

Capital gains. Gains realized on the sale or exchange of

capital assets—securities, real estate, personal property, etc.—which are held for personal use, are capital gains; losses so realized are capital losses. U.S. taxpayers must report capital gains and losses as though they resided in the U.S. regardless of the location of the assets sold.

Sale of stock in certain closely-held foreign corporations can result in a portion of any realized gain being treated as ordinary income. This rule, also applicable to residents of the U.S., applies to an individual who is a 10% or more shareholder of a foreign corporation more than 50% of whose voting stock is owned by U.S. persons each owning at least 10%.

The source of gains is discussed in the section on foreign tax credit limitations.

Pensions. Individuals who contribute to pension funds are entitled to recover their contributions free of U.S. tax. If the amount of payments received as a pension during the first 5 years of retirement exceeds the employee's contributions, the recipient pays no tax until an amount equal to his total contributions has been recovered. If such contributions are not entirely recovered within 3 years after retirement, a portion of each retirement payment is tax free and a portion is taxable.

ADJUSTED GROSS INCOME DEDUCTIONS EXEMPTIONS

ADJUSTED GROSS INCOME

After adding up all items of income to figure gross income, a taxpayer subtracts from gross income certain enumerated deductions in order to calculate adjusted gross income. Examples of such deductions allowed in calculating adjusted gross income (AGI) are: moving expenses, outside salesman expenses, transportation expenses, expenses for travel away from home, reimbursed expenses, alimony, etc. Beginning in 1978, individuals who qualify under either the BFFR or physical presence test are allowed the special foreign deductions described earlier. In addition, such individuals can claim the greater of the zero bracket amount or itemized deductions, and claim the foreign tax credit. In reviewing your expenses for deductible items, remember that no deduction is allowed for commutation and other personal expenses, except those described below.

ZERO BRACKET AMOUNT

The percentage standard deduction was replaced in 1977 by the "zero bracket amount." For 1978, the "zero bracket amount" is \$2,200 for unmarried individuals and heads of households, \$3,200 for married individuals filing jointly and surviving spouses, and \$1,600 for married individuals filing separately.

Tax rate schedules automatically incorporate the "zero bracket amount" so that it is not claimed as a deduction separately. If taxpayers' itemized deductions exceed their "zero bracket amount" only those "excess itemized deductions" (total itemized deductions less zero bracket amount) are deducted in the tax calculation. In general, this change in the mechanics of tax calculation should make no difference in the amount of tax.

MEDICAL EXPENSES

Expenses for medical care are deductible wherever incurred. One-half of medical insurance premiums (but not more than \$150) is deductible without regard to the percentage limits based on income. Expenditures for drugs are reduced by 1% of adjusted gross income; total medical expenses (including the portion of medical insurance premiums not already claimed) by

3% of adjusted gross income. U.S. taxpayers who qualify for the special foreign deductions or exclusions may have larger deductible medical expenses than if they had remained in the U.S. since their adjusted gross income will be lower.

CHARITABLE CONTRIBUTIONS

Amounts paid to qualified charitable organizations by U.S. taxpayers are deductible and are subject to the same limitations as in the U.S.—50% of adjusted gross income for contributions to public charities, 20% to private foundations, etc. Contributions are not deductible on a U.S. tax return if they are made to charitable organizations of other countries, unless permitted by treaty, e.g., Canada. If a U.S. charitable organization uses funds abroad, contributions to it are deductible if the use of the funds is controlled by the U.S. entity.

INTEREST

Interest expense on debts of U.S. taxpayers may be deducted without regard to the location of the creditor. However, no deduction is allowed for interest paid to purchase or carry bonds on which interest received is exempt from U.S. income tax. Interest paid in connection with investment activity is deductible but the deduction may not exceed \$10,000 per year plus net investment income (not including long-term capital gains). Prepaid interest is deductible only for the year to which it relates.

TAXES

U.S. taxpayers may deduct all real estate taxes; taxes on personal property which is located in the U.S.; state income taxes; sales, use and gasoline taxes imposed by a U.S. taxing jurisdiction. (The gasoline tax deduction will be eliminated beginning January 1, 1979.) If no foreign tax credit is claimed, income taxes levied by all levels of foreign governments may be deducted after adjustment for the tax on any excluded income. Foreign personal property, sales and use, gasoline, turnover and value-added taxes are not deductible, unless incurred as a business expense.

LOSSES

U.S. taxpayers may deduct casualty and theft losses in excess of \$100 for each casualty. Casualty losses include losses from

fire, storm, auto accident, vandalism, or shipwreck. Any loss or damage resulting from the shipping of household furnishings from one place to another is a casualty loss and, to the extent that it is not covered by insurance, is deductible.

RENTAL OF RESIDENCE

Many taxpayers who move abroad, particularly in recent years, may have decided to keep their homes in the United States as an investment and a hedge against inflation. If the home is rented there are certain rules which should be understood. If the property is rented at a profit (which would be unusual because of depreciation) the profit is taxable. A loss is deductible, but if the taxpayer uses the house (say on home leave) there are limits on any loss that may be deducted. Generally, no deduction is allowed for a loss from the rental of a residence if it is also used by the taxpayer for personal purposes, for more than either 14 days or 10% of the number of days actually rented during the year. This does not apply to interest, taxes, and casualty losses and such expenses are deductible as described above. These rules are intended to prevent the deduction of losses in connection with vacation homes (including yachts, ski huts, condominiums, etc.) which are used part of the year personally and rented part of the year but the rules actually apply to any residence wherever located. If personal use is less than the limits, a deduction is allowed for a proportionate share of the expenses (including depreciation) attributable to the rental of the unit. If the residence is rented for less than 15 days during the taxable year, then neither the income from the rent nor the deductions attributable to such rental are considered in the determination of taxable income.

If the taxpayer uses his home as his principal residence for part of the year and thereafter terminates such personal use, the 14-day 10% rule does not apply if the property is rented for at least 12 months to someone other than a member of the taxpayer's family.

BUSINESS AND INVESTMENT EXPENSES

Fees for tax advice and for tax return preparation, professional dues, fees for investment advice, employment agency fees, etc., are deductible. If the special foreign deductions are claimed, the full amount of the agency fee would be deductible.

The cost of maintaining an office in your home is deductible under limited circumstances. You may not deduct expenses (other than interest, taxes, and casualty losses) in excess of gross income attributable to the business use of a personal residence unless that use is on a *regular* and *exclusive* basis as a principal place of business or a place of business used by patients, clients or customers in the normal course of business. An employee's exclusive use of his residence must also be for the convenience of his employer.

TAX SHELTER

A popular technique for tax saving has been to invest in ventures described as "tax shelters," which in general provide substantial deductions in the earlier years of investment, deferring taxable income to later years where tax brackets would be lower with the possibility even of reporting the later income as capital gain. Since 1976, numerous changes apply to such investments which require a more careful analysis of the additional potential costs from tax sheltered investments, and a comparison of the return on a tax sheltered investment versus any other investment opportunity.

Space does not permit any detailed description of the rules. The treatments of prepaid interest and investment interest have already been described briefly. In addition, deductions for losses will be limited to amounts for which the investor is personally at risk to lose. Except for real estate activity, nonrecourse borrowing may not be taken into account.

FOREIGN CONVENTIONS

In 1977 U.S. taxpayers could not deduct the cost of attending more than two conventions, education seminars, or similar meetings a year held outside of the United States, its possessions or the Trust Territory of the Pacific. If more than two meetings were attended, the taxpayer chose which ones to deduct and this limitation applied to both the employer and employee. The Revenue Act of 1978 allows an employer to deduct the cost of more than two conventions per year if the employee includes the reimbursement in gross income.

The full cost of transportation for the trip is limited to the lowest coach or economy fare charged by a commercial airline. If at least 50% of the total days at the convention site is devoted to business related activities, the full amount of the transportation

cost is deductible. If less than 50% of total days are devoted to business, then only a pro rata portion of the transportation costs is deductible.

While at the convention site, the amount of deductible expenses for lodging, meals, etc., may not exceed the per diem allowances for U.S. civil servants stationed in the locality. Additionally, the taxpayer must attend at least two-thirds of the scheduled business activities and these in turn must be at least six hours a day.

If the convention is in a foreign country and the U.S. taxpayer is a bona fide resident of that country these rules do not apply.

EXEMPTIONS

U.S. taxpayers are entitled to exemptions for themselves and for those who qualify as their dependents. The amount for each regular personal exemption is \$750. This increases to \$1,000 for 1979.

A taxpayer is permitted to claim an additional exemption if he has reached the age of 65 or if he is blind. Additional exemptions also can be claimed by a taxpayer whose spouse has reached age 65 or who is blind. These additional exemptions are available even if the spouse is a nonresident alien and no election is made to file a joint return.

A person is entitled to the additional exemption for reaching age 65 if he or she reaches such age prior to the end of the year. Since a person becomes of age on the day before his birthday, a person who becomes 65 on January 1, 1979, may take the additional exemption in 1978.

Taxpayers are allowed additional exemptions for dependents. Four tests must be met if a person is to qualify as a dependent.

1. The dependent must be related to the taxpayer as a child, adopted child, grandchild, stepchild, brother, sister, stepbrother or sister, parent or grandparent, stepparent, niece, nephew, aunt or uncle, son- or daughter-in-law or is another member of the taxpayer's household in a relationship which is not in violation of the law.
2. The dependent must be a U.S. citizen or a resident of the U.S., Canada, or Mexico.

3. The gross income of the dependent cannot exceed \$750 unless he (or she) is the taxpayer's child and is either under 19 years of age or a full-time student.
4. The taxpayer must furnish over half of the individual's support for the year.

GENERAL TAX CREDIT

In 1978 taxpayers are allowed a credit of \$35 for each exemption (including exemptions for old age and blindness), or 2% of so much of taxable income (reduced by the "zero bracket amount") as does not exceed \$9,000, whichever is greater.

FOREIGN TAX CREDIT

A U.S. citizen may either deduct foreign income taxes in arriving at taxable income or claim them as a credit against his U.S. tax liability.

Use of the foreign tax credit usually results in lower taxes than does the deduction of foreign taxes since it permits a dollar-for-dollar offset of foreign income taxes against U.S. taxes.

Example: Mr. Smith, a single taxpayer, had income of \$20,000 in the U.K. upon which he incurred \$8,000 in United Kingdom taxes. Assume that he does not meet either the BFR or physical presence tests; he also has \$2,800 of other itemized deductions. He would compute his tax as follows:

	Foreign Taxes	
	Credited	Deducted
Gross Income	\$20,000	\$20,000
Itemized deductions:		
Total itemized	\$ 2,800	\$10,800
Less zero bracket amount	2,200	2,200
Excess itemized deductions	600	8,600
TAX TABLE INCOME	\$19,400	\$11,400
U.S. Tax (Less general tax credit)	\$ 3,795	\$ 1,528
Foreign tax credit	8,000	—
Net U.S. Tax	\$ —	\$ 1,528

A U.S. taxpayer can credit income taxes imposed by a foreign country, its political subdivisions, or a U.S. possession. Income, war profits, and excess profits taxes, as well as taxes paid in lieu of income taxes, can be claimed as foreign tax credits. For some countries, foreign social security taxes may be creditable.

Each year, an individual must either deduct *all* foreign income taxes or credit *all* such foreign taxes. Switching methods from year to year is permitted and may enable a taxpayer to reduce his income tax to the lowest level possible. After the election—deduction or credit—is made for the year it can be revoked at any time prior to the expiration of the period to file a

claim for refund (usually three years from due date or date of filing if the return was filed after the due date). Foreign taxes imposed on *excluded* income may not be claimed as a credit or as a deduction.

LIMITATION

The amount of foreign income taxes that may be credited is limited to the lesser of such taxes paid or accrued or the amount of the applicable limitation. The limitation is that part of the gross U.S. tax (before foreign tax credit) which is applicable to the taxable income from foreign sources.

$$\frac{\text{Foreign taxable income}}{\text{Total taxable income}} \times \text{Gross U.S. tax} = \text{Credit limitation}$$

Taxable income for this purpose is equal to tax table income reduced by the "zero bracket amount" but without any deduction for personal exemptions. The gross U.S. tax is computed after giving effect to personal exemptions and the general tax credit.

The calculation is made on an overall basis, i.e., income and taxes from all foreign sources are taken into account collectively.

Example: William Smith has U.S. source income of \$15,000 which was not taxed by any foreign country. His foreign source income and the foreign taxes on this income are:

	Income	Taxes
Country A	\$53,000	\$ 7,000
Country B	2,000	500
	<u>\$55,000</u>	<u>\$ 7,500</u>

Smith has \$30,000 of special foreign deductions, and other itemized deductions of \$5,000, none of which is specifically attributable to a particular source of income. He is single, under 65 years old and has no

dependents. His U.S. tax and credit limitation are computed as follows:

U.S. Income	\$15,000
Foreign source income	<u>55,000</u>
Total gross income	70,000
Less special foreign deductions	(30,000)
AGI	<u>40,000</u>
Less excess itemized deductions (\$5,000-\$2,200)	<u>(2,800)</u>
Tax table income	37,200
Less personal exemption	<u>(750)</u>
Taxable income	36,450
Less "zero bracket amount"	<u>(2,200)</u>
Plus personal exemptions	<u>750</u>
Taxable income reduced by "zero bracket amount" but without any deduction for personal exemption	<u>\$35,000</u>

Smith's tax is calculated as follows:

Taxable income (above)	\$36,450
Tax using tax rate schedule	<u>11,415</u>
Less general tax credit	<u>180</u>
Tax before foreign tax credit	\$11,235
Less foreign tax credit (see below)	<u>6,757</u>
Net United States Tax	<u>\$4,478</u>

The limitation formula is based on foreign source and U.S. source taxable income (before personal exemptions). This requires an allocation of allowable deductions between foreign and U.S. source income. The special foreign deductions have been allocated against foreign source income. The itemized deductions have been allocated on a percentage basis. The allocation of expenses is discussed in more detail on page 29.

Continuing the above example:

	Total	Foreign	U.S.
Gross Income	\$70,000	\$55,000	\$15,000
		79%	21%
Allocation of directly related deductions:			
Special Foreign deductions	\$30,000	\$30,000	\$ —
Allocation of indirectly related deductions:			
Itemized deductions	5,000	3,950	\$ 1,050
Total Deductions	<u>\$35,000</u>	<u>\$33,950</u>	<u>\$ 1,050</u>
Taxable income before personal exemptions	\$35,000	\$21,050	\$13,950
Zero Bracket Amount	2,200		
Personal Exemptions	(750)		
Taxable income per return	<u>\$36,450</u>		
Substituting in the formula:			
	$\frac{\$21,050}{\$35,000} \times \$11,235 = \$6,757$		

ALLOCATION OF EXPENSES

The foreign tax credit limitation is based on taxable income from foreign sources. The calculation of taxable income from foreign sources requires that gross income from such sources be reduced by three types of deductions:

1. those directly related to this income;
2. special foreign deductions; and
3. ratable portion of other deductions.

Items deducted in arriving at adjusted gross income generally relate to a specific item of income. As a result, there is usually little question as to whether the item should be allocated to domestic or foreign income. For example, the special foreign deductions would be allocable to foreign source income.

In the case of itemized deductions, some such as medical expenses, charitable contributions, etc., generally do not relate to a specific source of income and are, therefore, apportioned to domestic and foreign source income on the basis of gross income. If however, an itemized deduction relates to a specific item of income, it is allocated to such item. For example, interest

USE OF EXCESS CREDITS

U.S. taxpayers living abroad may incur foreign income taxes substantially in excess of those that can be used to offset U.S. income taxes. To the extent that these excess credits can be used, they will reduce U.S. income taxes otherwise payable. Foreign source income must be realized to increase the numerator of the limitation fraction if the excess credits are to provide their potential benefits.

SALES OF SECURITIES

Income from the sale of personal property has its source at the place where title to such property passes from the seller to the buyer. Taxpayers who are returning to the U.S. may sell securities abroad to realize foreign source income. However, gains from sales of stock or securities outside the country of residence will not be considered foreign source unless the country where the sale was made imposes a tax of less than 10% on the gain. It should be realized that U.S. source capital losses will reduce foreign source gains for limitation purposes.

FOREIGN INVESTMENTS

Dividends received from foreign securities are foreign source income. Investments in such securities may, therefore, be used to create foreign source income which will permit increased use of excess foreign tax credits. However, the possible U.S. tax benefit from the creation of this additional foreign source income may be offset by the additional foreign income taxes.

Investments in foreign securities should be considered even after the return to the U.S. upon completion of a foreign assignment. Dividend income received from such investments may provide an opportunity to use excess credits generated during the overseas assignment.

Investment in foreign debt obligations usually will not allow the taxpayer to use excess credits since the foreign tax credit limitation must, in most cases, be computed separately for foreign source interest income.

on money borrowed to purchase foreign securities would be allocated to foreign sources since the income derived from the securities would be foreign source income.

Those taxpayers who do not itemize their deductions and use the "zero bracket amount" must also apportion their "zero bracket amount" on the basis of gross income.

CASH OR ACCRUAL OPTION

Individuals may file income tax returns using either one of two accounting methods — cash or accrual. Individuals who use the cash method report income and expenses at the time cash is received or disbursed. Individuals who use the accrual method report their income and expenses in the year to which the transaction relates.

Most individuals use the cash basis to file income tax returns; thus, they normally credit foreign taxes in the year in which the taxes are paid or withheld. Taxpayers may, however, credit foreign taxes on the accrual basis even though they use the cash basis for all other purposes. Once the accrual method has been elected, it must be used in subsequent years or until permission to change to the cash method is obtained.

Taxpayers usually find it advantageous to accrue foreign income taxes. The use of the accrual method of accounting for foreign taxes prevents the loss of credit when foreign taxes are paid in a year during which no foreign source income was earned, a relatively common situation.

CARRYOVERS

In the above example Smith had foreign taxes of \$7,500 but was only allowed a credit of \$6,757. Foreign income taxes which cannot be credited in a particular year because they exceed the applicable limitation may be carried back two years and then forward five. They are subject, of course, to any limitation existing in the year to which they are carried.

As noted earlier, limits are calculated on an overall basis. Before 1976, some taxpayers computed credit limits under a per-country limit. Transitional rules for foreign tax credit carryovers and carrybacks are provided which permit carryovers and carrybacks of foreign tax credits between per-country years and overall years, but only for amounts which would have been allowed had the taxpayer continued the per-country basis.

BUSINESS TRIPS

Many U.S. taxpayers who once lived abroad are required to make frequent business trips abroad after their return from a foreign assignment. These taxpayers frequently have unused foreign tax credits. The income from the performance of personal services has its source at the place the services are performed. Therefore, the salary earned while on business trips abroad is foreign source income and is available to use the otherwise unusable excess credits.

MISCELLANEOUS MATTERS

FICA

A U.S. taxpayer who is employed by a U.S. employer is covered by Social Security whether he works in this country or abroad. His wages are subject to the withholding of FICA at the following rates:

Year	Rate of withholding	Wages subject to tax	Maximum tax
1977	5.85	\$16,500	\$965.25
1978	6.05	17,700	1,070.85
1979	6.13	22,900	1,403.77

While U.S. taxpayers who are employed by a foreign employer are not usually eligible for Social Security coverage, exception to this rule may apply to U.S. taxpayers who are employed by foreign subsidiaries of U.S. corporations. A U.S. corporation which owns at least 20% of the stock of a foreign corporation can enter into an agreement with the Secretary of the Treasury to provide Social Security coverage to U.S. taxpayers employed by that subsidiary. This coverage can be extended to any U.S. taxpayers employed by second tier foreign subsidiaries, if the first owns more than 50% of the shares of the second. The agreement with the Treasury must cover all U.S. taxpayers employed by a particular subsidiary; coverage may, however, be provided on a subsidiary-by-subsidary basis.

The corporation must agree to pay both the employer's and the employee's shares of the FICA taxes. (The employer and the employee usually arrange between themselves the portion—if any—of the FICA tax burden that is passed on to the latter; in most cases this is the employee's full share.) The corporation must also state that proper returns will be filed. This agreement is valid until terminated by either the corporation or the Treasury Department. The Treasury Department can terminate the agreement only if the corporation fails to comply with its terms.

U.S. taxpayers who are transferred from a U.S. corporation to its foreign subsidiary during the year may have two employers for that year. As a result, the corporation which has extended Social Security coverage to its foreign subsidiary's U.S. taxpayer employees must once again pay FICA taxes on their salaries.

SELF EMPLOYMENT TAXES

U.S. taxpayers abroad who are employees are not self-employed and cannot cover themselves for Social Security purposes merely by payment of self-employment taxes.

Self-employment taxes apply to self-employed individuals who reside abroad as though they had remained in the U.S.

The self-employment tax rates are:

Year	Rate of Tax	Self-employment income subject to tax	Maximum to be paid
1977	7.9	\$16,500	\$1,303.50
1978	8.1	17,700	1,433.70
1979	8.1	22,900	1,854.90

INDIVIDUAL RETIREMENT ACCOUNTS

A U.S. taxpayer who is not an active participant in a qualified retirement plan can establish an individual retirement account (IRA). A deduction from gross income for contributions to such a plan is allowed up to the lesser of 15% of taxable compensation (gross compensation minus earned income exclusion) or \$1,500. Income earned on contributions is exempt from tax. Both the contribution and the accumulated earnings are taxed upon distribution.

The above limitation is increased to \$1,750 for married individuals with a nonworking spouse if contributed to separate IRAs, one for each spouse up to \$875 each. Alternatively, the contributions may be made to a single IRA with a subaccount for each spouse. However, a joint return must be filed.

Effective for 1978, the time limit for making contributions to or establishing an IRA has been extended from 45 days after the close of the taxable year until the date of filing your return (including extensions).